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No. 87-1160

In the Supreme Court of the United States

October Term, 1987

DUQUESNE LIGHT COMPANY
and
PENNSYLVANIA POWER COMPANY,
Appellants

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.,
Appellees

ON APPEAL FROM THE SUPREME COURT OF PENNSYLVANIA

BRIEF FOR APPELLEE, PENNSYLVANIA PUBLIC UTILITY COMMISSION

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QUESTIONS PRESENTED

1. Whether Act 335, which mandates that the Pennsylvania Public Utility Commission exclude the cost of construction from consumer rates until the facilities provide service to the public, is unconstitutional on its face?

2. Whether the application of Act 335 to the electric companies' cancelled plant costs would result in rate orders whose total effect represent an unconstitutional taking of property in violation of the Fifth and Fourteenth Amendments to the United States Constitution?

3. Whether this Court should adopt a risk-free prudent investment theory as the constitutional standard applicable to public utility rate regulation, thereby insulating public utilities from most business risks and overruling *Hope Natural Gas* and *Permian Basin*?

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CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

United States Constitution, Amendment XIV, clause 3:

> [N]or shall any State deprive any person of . . . property, without due process of law . . .

Constitution of the Commonwealth of Pennsylvania, Article 1, Section 10, clause 3:

[N]or shall private property be taken or applied to public use, without authority of law and without just compensation being first made or secured.

Pennsylvania Public Utility Code:

66 Pa. C. S. §§101 et seq.
66 Pa. C. S. §1315 ("Act 335")

STATEMENT OF THE CASE

This is an appeal by two electric utilities ("the electric companies") of a decision of the Supreme Court of Pennsylvania interpreting an act of the Pennsylvania Legislature (Act effective December 30, 1982, Act No. 1982-335, P.L. 1473, 66 Pa. C. S. §1315) ("Act 335") (App. 23L-24L)[1] and Chapter 13 of the Pennsylvania Public Utility Code, 66 Pa. C. S. §§1301-1325 (App. 1L-39L).

The Pennsylvania Public Utility Commission is an arm of the legislature, and its powers are derived from the legislature. To determine what public policy shall be with respect to the regulation of public utilities is the ultimate prerogative of the legislature and not of the Public Utility Commission. *Bell Telephone Company of Pennsylvania v. Driscoll, et al.*, 343 Pa. 109, 21 A.2d 912 (1941), *City of Philadelphia v. Philadelphia Electric Co.*, 504 Pa. 312, 473 A.2d 997 (1984). It is the duty of the Pennsylvania Public Utility Commission to enforce the Public Utility Code. 66 Pa. C. S. §501.

On January 28, 1983, the Commission issued a decision on a general rate increase filing by Duquesne Light Company ("Duquesne") which granted an "increase in operating revenue of $105,850,000 or approximately 64 percent of the $165 million increase requested." (App. 126c) On April 11, 1984, the Commission issued a similar decision on a general rate increase filing made by Pennsylvania Power Company ("Penn Power")

[1] By order dated April 18, 1988, this Court granted Appellants' Motion to Dispense with Printing of the Joint Appendix. All references to "App." are to the Appellants' Appendix to Jurisdictional Statement.

granting "an increase in annual electric base rate operating revenue of approximately $15,364,000 . . . or approximately 77 percent of the requested base rate increase of $19,890,200." (App. 110e) In both orders, the Commission approved, on the basis of an earlier determination made in its Order in the CAPCO investigation (App. 1h, 1i) that both companies would be permitted to recover, over a ten year period, a return *of*, but no return *on* the prudently incurred costs associated with planning for four nuclear power plants that were cancelled by the electric companies on January 23, 1980 (App. 8h).

These decisions were appealed to the Commonwealth Court of Pennsylvania by the Consumer Advocate of Pennsylvania, an appellee in this proceeding. The Commonwealth Court of Pennsylvania, three of its members dissenting, sustained the rate orders (App. 1b) against an attack based upon an interpretation of a newly enacted statute, Act 335 (App. 23L-24L). The Supreme Court of Pennsylvania reversed in an order entered October 15, 1987 (App. 1a). Basing its decision upon provisions of the United States Constitution, the Pennsylvania Constitution and an interpretation of the Pennsylvania Public Utility Code, the Supreme Court of Pennsylvania held that the Pennsylvania Public Utility Commission had no power to issue a rate order which allows utilities to receive compensation through utility rates for property that is not "used and useful" in the public service.

On January 7, 1988, the electric companies filed a notice of appeal in the Supreme Court of Pennsylvania. Your Court noted probable jurisdiction on March 7, 1988.

SUMMARY OF ARGUMENT

This case involves the fundamental constitutional standard for reviewing public utility ratemaking orders established in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). Those landmark cases hold that rates which effectively

balance investor and consumer interests, measured with regard to the total effect of the rate order, are constitutionally permissible regardless of the particular ratemaking methods or elements used to achieve that "end result." In so holding, *Hope Natural Gas* and *Permian Basin* shifted the focus of the constitutional analysis from the valuation of specific assets to the total effect of the rate order on the capital invested in the enterprise.

The challenge to Act 335 raised by the electric companies fails to establish that the denial of cancelled plant costs in this case results in an unconstitutional taking of its property. Act 335 on its face applies to many potential situations where the compelling consumer interest in not paying for idle or partially completed facilities clearly outweighs the investor interest in a recovery of all expenditures and capital costs from consumers. As applied, Act 335 pertains to a relatively minor portion of the rate base of Duquesne Light Company and Pennsylvania Power Company and reduces the revenue of each by less than one percent.

The Pennsylvania Public Utility Commission, here appearing as appellee, originally issued orders in 1983 and 1984 which allowed recovery of the cancelled plant costs which are the subject of this appeal. It did so on the basis of what it perceived to be its discretion to regulate Pennsylvania utilities so as to secure "adequate, efficient, safe and reasonable service"[2] at "just and reasonable rates".[3] The Commission's judgment was partly based upon a view that it was beneficial from the standpoint of public policy to encourage utilities to cancel unnecessary construction and that allowing utilities to amortize the costs of such failed projects over a period of years would best achieve that result (App. 14d). As an administrative agency created by the legislature with only such powers as are delegated to it by the legislature, this Commission recognizes that the legislature may dictate what policy shall be adopted which touches upon the

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[2] 66 Pa. C. S. §1501.

[3] 66 Pa. C. S. §1301.

public interest. This case is brought to your Court by direct appeal pursuant to 28 U.S.C. §1257(2) from a decision of the Supreme Court of Pennsylvania. Inasmuch as that decision is independently grounded in the Constitution of the Commonwealth of Pennsylvania and in the laws of Pennsylvania the order below should be affirmed, or this appeal be dismissed for want of a substantial federal question. Pa. Const. Art. 1, §10, *National Wood Preservers, Inc. v. Commonwealth of Pennsylvania, etc.*, 489 Pa. 221, 414 A.2d 37 (1980), *appeal dismissed*, 449 U.S. 803, *Herb v. Pitcairn*, 324 U.S. 117, 125 (1945).

A. The Facial Attack Upon the Pennsylvania Public Utility Code

This case represents the first general attack in many years on the constitutional standard applicable to state utility ratemaking determinations. After *Hope Natural Gas* ended a fifty-year search for the philosopher's stone of constitutional rate regulation, rate regulation turned from a war of competing economic theories to a rational allocation of costs and risks between investors and consumers. The electric companies in this appeal ask that state legislation prohibiting the recovery of the costs of utility facilities which never become used and useful in the public service be found a *per se* violation of the Fifth Amendment prohibition against the taking of property without just compensation. The position of the electric companies is that the Pennsylvania General Assembly has no power to pass legislation which allocates the risks of the utility business to the utility and its investors. Instead, argue the electric companies, only the Pennsylvania Public Utility Commission can decide that, and only then on an *ad hoc* basis. The electric companies argue that state legislatures have no business deciding such policy matters. These arguments cannot be sustained.

The electric companies, by asking that Act 335 and the Pennsylvania Utility Code be struck down based upon their theoretical disagreement with the "used and useful" standard are making a "substantive due process" attack against a state

regulatory statute of a kind common in the days following *Lochner v. New York*, 198 U.S. 45 (1905). Such attacks were discredited in *Nebbia v. New York*, 291 U.S. 502 (1934). Substantive due process attacks against state economic regulation have been repudiated by your Court. *Ferguson v. Skrupa*, 372 U.S. 726, 729-31 (1963).

The facial attack is also invalid because the electric companies have failed to make the necessary showing that the "used and useful" rule is unconstitutional in all its applications. Moreover, the appellants have failed to demonstrate that it is unconstitutional as applied to the denial of the inclusion of cancelled plant costs in utility rate base for ratemaking purposes. Finally, the electric companies have not attempted to demonstrate that they have suffered any constitutional harm or deprivation of "investement backed" expectations by reason of the interpretation of the Pennsylvania Public Utility Code by the Supreme Court of Pennsylvania.

Board of Regents v. Roth, 408 U.S. 564 (1972) established the principle that one asserting the unlawful deprivation of a protected Fifth Amendment property interest must first establish the independent legal existence of such property interest or a reasonable expectation of such property interest. The electric companies in this case have failed to establish that the Commonwealth of Pennsylvania ever created a legal right or a reasonable expectation that the electric companies might charge their ratepayers for the costs of failed projects which are never devoted to the public service. Numerous state cases through the years testify to the continuing vitality of the "used and useful" rule, and that the rule serves to advance valid state interests in utility rate regulation.

The electric companies' radical suggestion that the United States Constitution requires the adoption of the "prudent investment" rule would force utility ratepayers to bear the business risks undertaken by the utilities and their shareholders. That position is clearly contrary to the doctrines of *Hope Natural Gas* and *Permian Basin* since "regulation does not insure that the business shall produce net revenues." The position, if adopted, would shift all of the risks of doing business from utility investors (who already earn a return which includes consideration for such risks) to utility ratepayers.[4] The facial attack is invalid and should be rejected.

B. The Attack Upon the Pennsylvania Public Utility Code as Applied

The electric companies have misstated the standard for constitutional analysis of a state order alleged to be confiscatory. *Hope Natural Gas* holds that rate orders must balance investor and consumer interests with respect to the *total* impact of the rate order. The electric companies have failed to demonstrate on this record that the total effect of the challenged rate orders, as modified by the "used and useful" rule will have any significant adverse impact on investor interests. The evidence indicates that no such harm can be established. Without a demonstration that "investor interests" are damaged, appellants have failed to make even a preliminary showing under *Hope Natural Gas* that an improper balancing of investor and consumer interests has been struck by the decision of the Supreme Court of Pennsylvania and this appeal must be dismissed.

Hope Natural Gas has shifted the focus of Constitutional inquiry from the valuation of specific assets to the rate order's total impact upon the capital invested in the enterprise. Although the electric companies recognize this fundamental shift in focus, they nevertheless challenge a state statute that affects only a relatively minor portion of the assets they seek to include

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[4] This facial attack implicates a broad range of public utility ratemaking determinations. Ratemaking determinations which could be affected by this case include the proper ratemaking treatment of excess generating capacity, construction work in progress, public utility plant (otherwise prudently constructed) idled by utility imprudence or ordinary business risk, and unusual or non-recurring expenses. These matters are frequent concerns of State utility ratemakers and State legislatures, and have been resolved in a variety of ways.

in their rate bases. The electric companies have not and cannot demonstrate on this record that the total effect of a rate order which disallows recovery of cancelled plant costs will fail to balance effectively investor and consumer interests. The electric utility investors were compensated in this case in the allowed rate of return for the risks associated with the utility business, including the risk that investors would receive no compensation for failed projects undertaken by the utility.

Additionally, the electric companies fail to demonstrate that they had any reasonable expectation in the recovery of all costs associated with plant that is never devoted to the public service. Act 335 serves to advance important state interests and is a valid exercise of the state police power. The constitution does not require that the state make utilities whole for competitive losses or for losses associated with the risks of the business.

C. The Invitation of the *Amici Curiae* To Adopt a Risk-Free "Prudent Investment" Rule

The arguments of the *amici curiae* also represent a radical departure from existing law. The Edison Electric Institute ("EEI") argues that *Hope Natural Gas* forbids the use of the "used and useful" formula which has been applied by the majority of states for the last 50 years. EEI goes on to argue that all prudent investment should be included in utility rate base for ratemaking purposes. That argument substantially enlarges the scope of this case which is limited on its facts to prudently initiated utility construction which is cancelled before completion. EEI would have the Court *forbid* the use of the "used and useful" standard and obligate ratepayers to pay a return upon obsolete, destroyed, redundant or uneconomic utility plant.

The Pennsylvania Electric Association ("PEA") denies that the Commonwealth of Pennsylvania has any legitimate interest in allocating the business risk of construction to utilities. PEA urges the Court to adopt its version of the "prudent investment" model as the standard of constitutional ratemaking for the fifty

states, essentially asking the Court to overrule *Hope Natural Gas*.

Adoption of the "prudent investment" rule would not be a panacea or reduce regulatory litigation as is suggested. Instead it would embroil the state and federal courts in an explosion of litigation over what constitutes constitutional "prudency" and "prudent investment." Moreover, it would completely ignore the substantial and legitimate consumer interest in not paying through utility rates for the costs of idle or excess capacity facilities. The balance struck by the *Hope Natural Gas* decision would be destroyed.

The Constitution does not embrace any particular economic theory or regulatory model nor does a constitutional challenge obligate your Court to decide between competing economic models.[5] There is no reason to believe that an asset-based Constitutional analysis of rate regulation, having failed of satisfactory application in the first half of the 20th century, can now succeed. The electric companies would have this Court prohibit state legislatures from legislating in areas that are located in the heart of the exercise of the police power secured to the states by the Tenth Amendment to the United States Constitution. That is an economic "substantive due process" argument rejected by this Court.

This case is particularly inappropriate for the Constitutional reinterpretation requested by the electric companies and *amici curiae*, since the facts demonstrate that the appellants have suffered little actual economic harm from the legislation

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[5] As Mr. Justice Holmes stated in his dissent to *Lochner v. New York*, 198 U.S. 45 (1905), "This case is decided upon an economic theory which a large part of the country does not entertain . . . The Fourteenth Amendment does not enact Mr. Herbert Spencer's *Social Statics*." That dissent has now become part of the Constitutional standard for review of the regulatory legislation of the States, *North Dakota State Board of Pharmacy v. Snyder's Drug Stores, Inc.*, 414 U.S. 156 (1973); *Harper et al. v. Virginia State Board of Elections*, 383 U.S. 663 (1966).

they facially attack. The Pennsylvania Public Utility Commission respectfully submits that the electric companies have established no harm amounting to a deprivation of property without due process or without just compensation. This case represents an unsuitable basis for the radical revision of the constitutional law of state public utility rate regulation. The decision of the Supreme Court of Pennsylvania rests upon independent state constitutional and statutory grounds and should be affirmed.

ARGUMENT

I. The Appellants' Facial Attack Upon the Pennsylvania Public Utility Code Is Invalid

The regulation of public utility rates is one of the oldest forms of exercise of the police power. *Munn v. Illinois*, 94 U.S. 113, 125 (1877). With the growth of utilities in the latter half of the 19th century came the historical experience that such monopolies, unchecked, inevitably abuse their economic power by "setting exorbitant rates, discriminating among customers, and engaging in predatory behavior not only against the public but against each other."[6] The lessons of the first half of the 20th century were that judicial attempts to prescribe detailed constitutional ratemaking procedures inevitably resulted in failure. From the initial attempt in *Smyth v. Ames*, 169 U.S. 466 (1898) until the landmark case of *Hope Natural Gas* in 1944, your Court struggled with utility ratemaking by prescribing ratemaking formulas, independently reviewing evidence, and weighing competing economic theories.

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[6] Siegel, *Understanding the Lochner Era: Lessons from the Controversy over Railroad and Utility Rate Regulation*, 70 Va. L. Rev. 187 (1984).

A. A facial attack must be judged by the rules of standing.

It is a well settled principle of constitutional standing that a party asserting the invalidity of an enactment must assert its own claims, and not those of others. A facial attack is a claim that the "statute is invalid *in toto*—and therefore incapable of any valid application . . ." *Steffel v. Thompson*, 415 U.S. 452, 474 (1974).

A facial attack upon a statute or statutory scheme fails unless the challenger can establish that the enactment cannot be constitutionally applied in any conceivable manner.[7] Moreover, where an appellant launches a generalized attack against a statute based upon facts which apply to only one of the many possible situations, jurisdiction will not be exercised unless the case "tenders the underlying constitutional issues in clean-cut and concrete form." *Socialist Labor Party v. Gilligan*, 406 U.S. 583, 588 (1972) (quoting *Rescue Army v. Municipal Court*, 331 U.S. 549 (1947)). The reason for the principle is clear. Constitutional issues should not be decided in a vacuum lest they be decided wrongly. Invalidation of a statute which may be constitutionally applied does violence to the appellate process.[8] Similarly, a facial attack is invalid if the challenged statute can be constitutionally applied to the challenger[9] or if the challenger cannot show that the statute has actually deprived him of a constitutionally protected interest.[10]

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[7] Another ground may be that the statute is impermissibly vague, or overbroad in a manner that chills the exercise of protected rights. *Village of Hoffman Estates v. The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 495-504 (1982). There is no such claim by the appellants in this case.

[8] *See generally*, Sedler, *The Assertion of Constitutional Jus Tertii: A Substantive Approach*, 70 Calif. Law Rev. 1308 (1982).

[9] *Village of Hoffman Estates v. The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489 (1982).

[10] *See Schlesinger v. Reservists Committee to Stop the War*, 418 U.S. 208, 221-223 (1974). In *Schlesinger*, your Court found that taxpayers had no standing to assert that the Incompatibility Clause (U.S. Const.

B. The electric companies have no standing to make a facial attack against the Public Utility Code.

Duquesne and Penn Power's facial challenge to Act 335 and the Pennsylvania Public Utility Code as interpreted by the Pennsylvania Supreme Court is invalid because the appellants have not demonstrated that the statutory scheme is incapable of Constitutional application. The statute would apply to more than the single factual situation the appellants have presented to this Court.

Duquesne and Penn Power's facial challenge is invalid because the appellants have not demonstrated that the statutory scheme under attack, applied to the rate treatment of cancelled plant costs, facially works an unconstitutional deprivation of property without due process or without compensation.

Finally, the facial challenge is invalid because the appellants have failed to demonstrate upon the facts of this case that either of them has suffered any unconstitutional deprivation of property without due process or without compensation.

Two recent cases illustrate the burden an appellant must meet before initiating a facial attack upon a regulatory statute under the Takings Clause.

In *Pennell v. City of San Jose,* U.S. , 108 S.Ct. 849 (1988) the facial attack failed because the appellants could not show that the challenged ordinance was incapable of being constitutionally applied, and additionally because the landlords could not show that they had suffered harm amounting to a deprivation of a constitutionally secured right. The landlord's association challenged a rent control ordinance of the City of San Jose on the grounds that it included a provision requiring that

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Art. 1, §6, cl. 2, 8) prohibits Members of Congress from holding reserve officer commissions in the United States Armed Forces. Your Court held that a basic requirement of constitutional adjudication is that a party asking for such relief demonstrate concrete injury and a discrete factual context for relief. Mere desire to obtain sweeping relief is not enough.

its rent control hearing officers consider whether the effect of a proposed rent increase would constitute an unreasonably severe financial or economic hardship on a particular tenant. If so, the hearing officer was empowered to disallow such increase or any part thereof. The landlords' association's challenge was held to be premature.

It was held that there was a valid state interest in protecting tenants from severe economic hardship. Your Court emphasized the important state interest in rate regulation of monopoly businesses. Citing *Permian Basin*, 390 U.S. 747, 769-70 (1968) and quoting *Nebbia v. New York*, 291 U.S. 502, 539 (1934), your Court held that price control is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and that the challenged ordinance was facially in accord with the powers of the City of San Jose.

In *Hodel v. Virginia Surface Mining and Reclamation Association, Inc.*, 452 U.S. 264, 294-96 (1981) a facial challenge to a statute regulating coal mining operations which arose under the Takings Clause was rejected because of the absence of a factual situation which made a constitutional analysis necessary. The test applied to that facial challenge was whether the statute denied "an owner economically viable use of his land." Although there might be circumstances where the mining regulations might impose costs which would make mining prohibitive, your Court concluded that there are clearly other economically viable uses for properties affected by the act.[11]

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[11] *Hodel*, and other cases involving state regulation of, or intrusion upon real estate should be distinguished as involving a property interest which your Court has recently held to be fundamental. *Hodel* involved a regulation affecting the use of specific land or other property, rather than the regulation of rates. *Kaiser Aetna v. United States*, 444 U.S. 164 (1979), *Keystone Bituminous Coal Association v. DeBenedictis*, U.S. , 107 S.Ct. 1232 (1987), *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978) and *United States v. Causby*, 328 U.S. 256

Taken together, the cases illustrate that a facial attack upon a statute which regulated rates or prices must fail unless it is predicated upon an actual application of the statute to the challenger which deprives the challenger of a constitutionally protected interest, and further, that the facts clearly illustrate that the statute cannot be constitutionally applied in any other manner. The instant facial challenge fails because, although the statute *has* been applied to the Appellants, they have not been deprived of any constitutionally protected interest, nor has it been shown that the statute is unconstitutional in all its applications.

The appellants claim that their facial attack upon Act 335 must include an attack upon the entire ratemaking chapter of the Pennsylvania Public Utility Code, 66 Pa. C. S. §§1301-1325 (App. 11-391)[12] because the Supreme Court of Pennsylvania held that the prohibition of Act 335 merely restated existing law with regard to "used and useful" plant and that other types of utilities are equally prohibited from recovering those costs associated with cancelled plants through utility rates.

The specific language of Section 1315 which is the basis of this appeal is as follows:

> Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may

(1946) cited by appellants in their footnote 25, as well as *Nollan v. California Coastal Commission,* U.S. , 107 S.Ct. 3141 (1987), cited by *amici* EEI and PEA also involved regulation of the use of specific land or property. As the instant appeal involves economic regulation, the degree of regulation approved in the above cases is *a fortiori* permissible in the sphere of economic regulation.

[12] It is not immediately apparent whether the appellants also seek to challenge laws enacted subsequent to 1982 which amend Chapter 13 of the Pennsylvania Public Utility Code. 66 Pa. C. S. §§1316-1325 were enacted subsequent to 1982. Sections 1302, 1307, 1308 and 1311 were amended subsequent to 1982.

> be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric property shall be deemed used and useful until it is presently providing utility service to the customers.

66 Pa. C. S. §1315.

As interpreted by the Supreme Court of Pennsylvania, this language merely restates and reconfirms existing Pennsylvania law, which is that:

> [N]o utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service.

Barasch v. Pennsylvania Public Utility Commission, 516 Pa. 142, 532 A.2d 325, 338 (1987) (App. 28a-29a).

Although the facts of this case apply specifically to the exclusion from rate base of prudently initiated generating plant construction which is prudently cancelled on a timely basis, it is apparent that the appeal here seeks to challenge any application of the "used and useful" rule as unconstitutional. The "used and useful" rule applies to six situations in which the police power of the state is strongly implicated. In the following discussion "plant" refers to any capital asset that might be claimed in a utility's rate base, that is, an asset with a life of more than one year.[13]

[13] Expenditures for goods or services which have a service life of less than one year are considered expenses for ratemaking purposes.

The situations include:

—Prudently initiated, prudently cancelled construction. This situation is represented by the instant appeal.

—Imprudently initiated construction. This would include plant that was imprudently initiated or constructed and which was either later cancelled prior to completion, or actually completed despite a lack of need for such plant. Typical of such imprudent construction might be a large generating plant initiated without an adequate load forecast, or a transmission line which is imprudently oversized for the area which it would serve.

—Imprudently cancelled construction. Such projects might be initiated pursuant to prudently conducted studies, but which cannot be completed due to imprudent utility management, such as incompetent management of construction costs, failure to obtain continued financing, or loss of necessary permits due to violation of safety or environmental laws.

—Plant not used to provide utility service. This plant might include imprudently constructed excess capacity, plant used to provide non-utility, non-regulated service (e.g.: a utility owned coal mine which provides coal at a higher than market rate), or such obviously imprudent expenditures as valuable paintings or artwork, aircraft not used for utility business related travel, or other lavish or extravagant expenditures of a capital nature.

—Plant that is obsolete, inefficient or surplus. Such plant would include clearly obsolete or inefficient plant, plant not currently providing service and with no reasonable prospect of providing such service, or plant which cannot be operated due to physical deterioration, damage or destruction or plant which is idled due to health, safety or environmental prohibitions.

—Plant still under construction, but not yet completed. Pennsylvania currently permits utilities to claim some

plant (denoted as construction work in progress or CWIP) in rate base under statutorily defined conditions. Ordinarily, however, the utility is required to book its financing costs in a regulatory account and such costs are added to rate base at the time such plant goes into service. This provision is known as 'allowances for funds used during construction', or AFUDC, for electric utilities. The states are split on whether CWIP or AFUDC is the preferred method for accounting for the capital costs of plant under construction. *See generally,* C. F. Phillips, Jr., *The Regulation of Public Utilities,* 322-325 (1984).[14]

C. The electric companies have not addressed all applications of the statutes they attack.

The appellants' facial attack fails because they have not demonstrated that all applications of the Public Utility Code's prohibition against charging ratepayers for the cost of plant not "used and useful" violates the constitutional prohibitions of the Takings Clause of the Fifth Amendment to the United States Constitution.

In order to do so, the Appellants would have had to demonstrate that utilities have a reasonable expectation for recovery of the cost of investment that would be denominated as not "used and useful" in each of the above situations. *Board of Regents v. Roth,* 408 U.S. 564 (1972) rejects the idea that one asserting the unlawful deprivation of a protected Fifth Amendment property interest may do so on the mere basis of a desire to have a hearing on the issue without first demonstrating an

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[14] It should be noted that the "prudent investment" rule, offered as a substitute by the appellants and *amici* would facially seem to allow exclusion of plant that was imprudent when built or purchased. Proving imprudency is a difficult undertaking in even the most blatant situation and is productive of complex and protracted litigation. It is rational for the legislature to conclude that the public interest may well be better served by a clear, easily applied rule that provides a clear warning to utility managers and investors that the utility bears the risk of the business, not the public.

independent source of law or agreement creating the property interest. The electric companies' facial attack against the Pennsylvania Public Utility Code is essentially a "substantive due process" attack against state economic regulation.

D. The facial attack is an invalid economic substantive due process attack.

The electric companies, by asking that the Pennsylvania Utility Code be struck down based upon their disagreement with the "used and useful" standard are making a "substantive due process" attack against a state regulatory statute of a kind common in the days following *Lochner v. New York*, 198 U.S. 45 (1905) which has been repudiated by your Court. *Ferguson v. Skrupa*, 372 U.S. 726, 729-31 at n. 8 (1963). It is no longer acceptable to submit an alternative economic theory as the basis of a demonstration of the lack of wisdom of a state statute and then assert that the United States Constitution has been therefore violated. States "have power to legislate against what are found to be injurious practices in their internal commercial and business affairs, so long as their laws do not run afoul of some specific federal constitutional prohibition, or of some valid federal law." *Ferguson*, at 730-31 (citing *Lincoln Federal Labor Union, etc. v. Northwestern Iron & Metal Co.*, 335 U.S. 525, 536 (1949)). As further explained in *New Orleans v. Dukes*, 427 U.S. 297, 304 (1976):

> States are accorded wide latitude in the regulation of their local economies under their police powers, and rational distinctions may be made with substantially less than mathematical exactitude . . . the judiciary may not sit as a superlegislature to judge the wisdom or desirability of legislative policy determinations made in areas that neither affect fundamental rights nor proceed along suspect lines[.]

E. The electric companies have not demonstrated the independent existence of a property right to recover cancellation costs through public utility rates.

A person claiming the protection of the takings clause must first establish the independent legal existence of such property interest or a reasonable expectation of such property interest. The electric companies in this case have failed to establish that the Commonwealth of Pennsylvania ever created a legal right or a reasonable expectation that the electric companies might charge their ratepayers for the costs of failed projects which are never devoted to the public service. The history of Pennsylvania rate regulation demonstrates quite the opposite. Without the existence of such right or expectation, the electric companies cannot invoke the Takings Clause of the U.S. Constitution and this appeal must be dismissed.

"A mere unilateral expectation or an abstract need is not a property interest entitled to protection." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980), *Kaiser Aetna v. United States*, 444 U.S. 164, 179 (1979). The electric companies have attempted to create a property right in cancelled plant costs by citing a 1972 Pennsylvania Public Utility Commission Investigation order, *Investigation of the Need for Additional Electric Generating and Transmission Facilities; Investigation Docket No. 138*, 46 Pa. P.U.C. 23 (1972) (hereinafter *"I.D. 138"*). Yet a reading of that order reveals that the Pennsylvania Public Utility Commission did not announce that it was generally abandoning the "used and useful" rule, nor did it order Duquesne Light Company or Pennsylvania Power Company (or any other utility) to construct additional facilities. What the Commission actually said was:

> The Commission is now concerned about whether current plans are satisfactory to meet projected future needs for electric power. At the same time, the Commission is aware of two possible changes in conditions which

may affect the demands for electric power during the next several decades:

> 1. A developing trend to conserve the use of electric service and a moratorium on the promotion of total electric residential living units.
>
> 2. Environmental regulation at both federal and state levels could limit the ability of the electric utility industry to meet forecasted demands for power.

It is incumbent upon the Commission to determine whether or not an electric energy shortage will develop and have an adverse affect upon the electric utility industry or if the industry's construction program calls for excessive capital investment at the expense of existing rate paying customers. It is hypothetical that such programs will attract prospective customers who may be denied energy from gas suppliers and further distort the demand for power.

I.D. 138, at 25-26.

Accordingly the Commission ordered that Pennsylvania electric companies file annual statements of generating capacity, customer demand, forecasts of load growth, schedule of projected additions, existing generating plants, pollution abatement facilities construction costs, operating costs and filings of F.P.C. Form 12. No other formal action was taken by the Commission in connection with this investigation. Nowhere in that order did the Commission mandate that the electric utilities build the four large scale nuclear power plants that were later cancelled. Nowhere in that order did the Commission announce that utility investors would be relieved from the risks of the utility business.

By contrast, the Commission continued to apply the "used and useful" rule in a variety of contexts, as it had for many years. There has never been a doctrine of "social contract" or "social compact" in Pennsylvania in which utilities were relieved from the "used and useful" rule as the electric companies and the *amici* suggest.[15]

The Pennsylvania Public Utility Commission has applied the "used and useful" rule at least since 1916, when in *Thayer v. Beaver Valley Water Company*, P.U.R. 1916E 962, 978-81 (1916) the commission (then known as the Pennsylvania Public Service Commission) disallowed a variety of water transmission lines, reservoirs and other structures from the rate base of a water company because they were not used and useful. The Public Service Commission stated, "The fact that the duplicate pipelines and building are being used does not support the claim that they constitute value for rate making; they may be 'used' but they are not 'useful' because they are unnecessary." *Thayer*, at 979.

A large number of similar decisions have been made by the Pennsylvania Commission since. Recent examples from the period 1971-1981 include:

> *Garber v. Philadelphia Suburban Water Co.*, 45 Pa.P.U.C. 118, 128, 129 (1971) (houses occupied by utility personnel as residences not used and useful); *Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Co.*, 46 Pa.P.U.C. 288, 296 (1972) (unused land parcel); *Pennsylvania Public Utility Commission, et al. v. Consolidated Water Company of Coudersport*, 46 Pa.P.U.C. 620, 626 (1973) (unused reservoir and plant); *Pennsylvania Public Utility Commission et al. v. Duquesne Light Co.*, 48 Pa.P.U.C. 14, 26 (1974) (three unused generating stations); *Pennsylvania Public Utility Commission*,

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[15] An extensive search of authority among the states has failed to turn up even a single example of a state court or regulatory agency which has adopted the electric companies' social contract theory. In the *single* decision found which discusses the claim, it was rejected. *Washington Utilities and Transportation Commission*, Cause No. U-85-50, et al. (Washington Utilities and Transportation Commission, 1986) (slip opinion).

et al. v. Philadelphia Suburban Water Co., 48 Pa.P.U.C. 358, 369 (1974) (unused land parcel); *Pennsylvania Public Utility Commission v. Allegheny County Steam Heating Co.*, 49 Pa.P.U.C. 82, 90 (1975) (construction work in progress); *Pennsylvania Public Utility Commission v. Metropolitan Edison Co.*, 50 Pa.P.U.C. 82, 94-103 (1976) (retired plant, land held for future use, unused common plant facilities); *Pennsylvania Public Utility Commission v. Pennsylvania Electric Co.*, 51 Pa.P.U.C. 649, 654 (1978) (repairs to faulty construction, unused coal lands); *Pennsylvania Public Utility Commission v. Metropolitan Edison Co.*, 53 Pa.P.U.C. 329, 332-34, 29 PUR4th 502 (1979) (damaged nuclear power plant out of service); *Pennsylvania Public Utility Commission v. West Penn Power Co.*, 53 Pa. P.U.C. 410, 419, 32 PUR4th 245, 252-3 (1979) (construction work in progress, plant held for future use); *Pennsylvania Public Utility Commission v. Philadelphia Electric Co.*, 54 Pa.P.U.C. 1, 7, 33 PUR4th 319, (1980) (Commission, while allowing oversized gas line in rate base, declares that it adheres to the used and useful standard regardless of the prudence of construction); *Pennsylvania Public Utility Commission v. Pennsylvania Power and Light Co.*, 54 Pa.P.U.C. 645, 648-53 (1981) (construction work in progress, land held for future use and unused, expensive and risky coal reserves)

The "used and useful" rule has been applied over a long period of time, both in Pennsylvania and in other jurisdictions.[16] These repeated applications of the "used and useful" rule provide ample notice to utility investors that they bear the risk of reduced or no compensation for the investment in idle, incomplete or excess capacity facilities.

Similarly, the Courts of Pennsylvania have recognized the "used and useful" rule is a valid ratemaking principle and have

[16] *See generally*, the large number of commission and court cases applying the "used and useful rule" from 1953-1982 in the P.U.R. Digest, 3d Series under the topics *Valuation*, §§193-215 and *Expenses*, §35.

repeatedly affirmed its use.[17] The rule is contained in the text of several provisions of the Pennsylvania Public Utility Code.[18]

F. The "used and useful" rule protects a rational state interest in risk allocation.

The missing part of the puzzle here is the historical allocation of business risk. If investors in public utility enterprises are aware of the existence of the "used and useful" rule and invest anyway, there can be *no* investment backed expectation that the rule will not be applied. In fact, that is the case. In view of the long history of application of the rule by the Pennsylvania commission and by other state commissions, it would be hard for any investor at all interested in the subject of rate regulation to assert that the rule is now a surprise. In fact, the relationship between the used and useful rule and the assumption of risk by investors has been consistently recognized by

[17] *See Schuylkill Valley Lines, Inc. v. Pennsylvania Public Utility Commission*, 165 Pa. Superior Ct. 393, 398, 68 A.2d 448, 451 (1949), *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 171 Pa. Superior Ct. 187, 200-01, 90 A.2d 607, 614-15, (1952), *Philadelphia v. Pennsylvania Public Utility Commission*, 173 Pa. Superior Ct. 38, 53, 95 A.2d 244, 251 (1953), *Riverton Consolidated Water Co. v. Pennsylvania Public Utility Commission*, 186 Pa. Superior Ct. 1, 11, 140 A.2d 114, 119 (1958), *Bell Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission*, 47 Pa. Commonwealth Ct. 614, 629-30, 408 A.2d 917, 925 (1979), *UGI Corp. v. Pennsylvania Public Utility Commission*, 49 Pa. Commonwealth Ct. 69, 78, 410 A.2d 923, 928 (1980), *Park Towne v. Pennsylvania Public Utility Commission*, 61 Pa. Commonwealth Ct. 285, 293-94, 433 A.2d 610, 615 (1981), *Philadelphia Electric Co. v. Pennsylvania Public Utility Commission*, 61 Pa. Commonwealth Ct. 325, 329-30, 433 A.2d 620, 623 (1981), *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*, 509 Pa. 324, 502 A.2d 130 (1985), *appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission*, 476 U.S. 1137 (1986), *Pennsylvania Power & Light Co. v. Pennsylvania Public Utility Commission*, 101 Pa. Commonwealth Ct. 370, 376-77, 516 A.2d 426, 430 (1986).

[18] *See* 66 Pa. C. S. §§1310(a), (d). "Rate Base" is defined at 66 Pa. C. S. §102 as "[t]he whole or any part of the property of a public utility which is used and useful in the public service."

commentators ever since *Hope Natural Gas*. *See* Hale, *Utility Regulation in the Light of the Hope Natural Gas Case*, 44 Harv. L. Rev. 488 (1944), H. Brown, *The Ghosts of the Hope Natural Gas Decision*, 32 Calif. L. Rev. 398 (1944). *See also* Note, *Accounting for Extraordinary Obsolescence*, 65 Harv. L. Rev. 1431, 1442-43 (1952), where a student commentator, discussing *Washington Gas Light Co. v. Baker*, 188 F.2d 11 (1950), *certiorari denied*, 340 U.S. 952 (1951), demonstrated that the long-standing use of the "used and useful" rule makes it almost impossible for a utility to show that its investors have not been compensated for the risk that the rule will be applied.

In a more recent commentary, Drobak, *From Turnpike to Nuclear Power: Constitutional Limits on Utility Rate Regulation*, 65 B.U.L.Rev. 65, 123 (1985) (hereinafter *Drobak*), the allocation of risk imposed by application of the "used and useful" rule was shown to be a matter of policy within the limits of state police power:

> Imposing cancellation costs on shareholders makes them bear the risks of changes in the energy and capital markets and the regulatory risks inherent in the use of such a potentially dangerous and heavily regulated product as nuclear power. As a matter of sound utility regulation, other principles require that customers bear some of the cancellation costs (footnote omitted). As a matter of constitutional law, however, the justifications for imposing the costs on investors support the constitutionality of the kind of rate order [which disallows power plant cancellation costs even if substantial]. The Hope doctrine and the takings cases support no other conclusion.

Drobak, 65 B.U.L.Rev. at 123-24.

Pennsylvania rate orders do in fact consider business risk when fixing rates. Consideration of such risk occurs in the calculation of the fair return which a utility may earn upon its used and useful rate base. The calculation is based upon an analysis of the cost of equity in the capital markets. For

Duquesne Light Company, that assessment is discussed in a portion of Commission's rate order printed at App. 74c-93c. Duquesne's witness Brennan testified that the return to an equity investor includes three factors:

> (1) bare rent or the basic time cost (value) of money; (2) an inflation factor; and, (3) the risk element (equity risk premium) to reflect the degree of risk inherent in the difference between a low risk, near guaranteed obligation, such as a utility long-term debt investment, and a utility common stock investment.

(App. 84c-85c) Pennsylvania Power's witness Hanley offered similar testimony (App. 46e-47e).

The Commission's rate awards include a greater return for equity holders because of the increased risks that such shareholders bear. The record demonstrates that Duquesne Light Company was granted a 16.14% rate of return on equity, a figure substantially higher than the 9.42% cost of debt, in order to recognize and compensate the utility for its business risks (App. 79c and 93c). For Pennsylvania Power Company a similar incremental allowance was granted to recognize the degree of business risk faced by equity investors. The allowed rate of return on equity was 15.72%, again substantially higher than the 10.25% cost of debt (App. 48e). It should not be a novel or controversial proposition that the owners of the business should bear the risks of the business. Indeed, the risk of reduced compensation, or no compensation for non-used and useful facilities, has always been a fundamental and recognized risk of the utility business. Otherwise there would be no justification for granting higher returns to equity investors than the current cost of debt.

When *amicus* EEI characterizes the events leading to the cancellation of the plants involved in this appeal as "unexpected, unforeseeable developments"[19] at page 8 of its

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[19] It is axiomatic that while the existence of business risk is predictable, its individual occurrences are not. Thus, such occurrences are always an unexpected, unforeseen development.

Brief, they belie nearly 100 years of state and federal court precedent which establishes the police power of the state to allocate the risk of failed projects to utility investors. When PEA denies that there is any "state interest that could possibly justify" requiring a utility to bear the risks of construction, it is asking for a radical redefinition of the policy making and police powers of the States.

It is noted that the appellants and supporting *amici* rely heavily upon recent cases of this Court dealing with governmental intrusion or physical appropriation of property. This reliance is misplaced. Since this case involves ratemaking, not the physical control or intrusion upon land or property, the assertion that investors have a reasonable expectation in the recovery through rates of the cost of plant that may later be excluded from rate base because it is not used and useful does not end the constitutional inquiry. It must also be shown that the application of the "used and useful" rule would so fundamentally frustrate a utility from earning a return upon its total investment that the basic "investor interest" of *Hope Natural Gas* - would be imperilled. That would require a showing that such a utility would be unable to earn a return upon its total investment sufficient to attract capital, maintain a reasonable standard of credit, earn a return commensurate with comparable risk enterprises, and maintain service to the public.

In *Keystone Bituminous Coal*, U.S. , 107 S.Ct. 1232, 1247-48 (1987) your Court found that a taking was not established because despite the mining regulations, mining was still commercially practicable. In *Hodel*, 452 U.S. 264, 295-96 the facial attack upon mining regulations was rejected because, even if mining were to be made impractical, the coal lands could be devoted to other uses, such as timber, recreation and so forth. Where, as in this case, there is no actual physical appropriation or burden upon realty or personalty, the electric company's facial attack is far weaker. In many applications of the "used and useful" rule, the plant continues to have economic value and can be sold or devoted to other uses. The "used and

useful" rule simply prevents it from being forcibly charged to rate payers.[20]

Finally, even if complete destruction of the value of the failed investment were demonstrated, Appellants would have to demonstrate that, upon balancing the investor and consumer interest, denial of the recovery of such investment through utility rates would not serve a valid public purpose. *Hope Natural Gas, Permian Basin*. The electric companies have failed to make any of the above showings in their facial attack upon the Pennsylvania Public Utility Code.

G. Act 335 is a valid exercise of the police power.

The very heart of state rate regulation is in the protection of the public interest in obtaining adequate, efficient, safe and reasonable public utility service at just and reasonable rates. The nature of public regulation of privately owned utilities makes it a rational goal to encourage the provision of such beneficial service through rate regulation, rather than through direct governmental intervention in the operations of regulated utilities. The courts of Pennsylvania have in fact repeatedly held that the Pennsylvania Public Utility Commission may not act as a "super board of directors" in judgment of all the expenditures made by a utility. *Bell Telephone Co. of Pennsylvania v. Driscoll*, 343 Pa. 109, 118, 21 A.2d 912, 916 (1941). It is literally impossible for any regulatory commission to supervise utility operations on a day to day basis.

Despite the electric companies' false assertion that the Commission's order in *I.D. 138*, 46 Pa. P.U.C. 23 (1972) gave them the "go ahead" to build additional capacity without fear of the application of the "used and useful" rule, that was not what

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[20] Examples might include excess generating plant capacity, lavish or exorbitant company facilities, land owned by the utility with no definite planned use, obsolete plant with scrap value and so forth. Such items, excluded from rate base, will still have economic value which is not destroyed by a refusal by the State to allow a recovery of the cost of such plant through public utility rates.

that order expressed or intended. The Commission did not have the power to dictate utility generating construction programs. *Bell Telephone*, at 118, 21 A.2d at 916.[21] It is significant that the electric companies have never demonstrated that they actually and reasonably relied upon that order as relieving them from the risks associated with the utility business. In order to claim a constitutional investment backed expectation that the Commonwealth of Pennsylvania would permit the recovery through rates of the costs of failed generating construction, the

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[21] In fact the electric companies attempted to derail the CAPCO investigation below, asserting that the Pennsylvania Public Utility Commission lacked the jurisdiction to even inquire into their generation construction plans. The ALJ below commented on this in his order. App. 6h-7h. The electric companies' May 14, 1980 *Petition to Terminate the Investigation* was denied. The petition stated in part:

> It should be noted again that this Commission lacks jurisdiction over the planning and siting of electric generating stations. As a result a utility may plan and construct a generating station . . . without the need for the express approval of this Commission. The first time that the utility must seek this Commission's approval is in the rate proceeding subsequent to its being placed in service . . . [and] this Commission also has no specific jurisdiction also over the selection of the type of fuel used to generate the electricity . . . It is hornbook law that the Commission is not a superboard of directors managing the affairs of a utility. This Commission was not established for the purpose of telling a utility when to place a generating plant on line, nor is it proper for a quasi-judicial body to work out the ratemaking treatment of a plant . . . outside the context of a rate proceeding. (citing the Administrative Law Judge's decision in Pennsylvania Public Utility Commission v. Philadelphia Electric Co., R-79060865, slip op. at 63-73 (Pa.P.U.C. 1980)

App. 7h.

The CAPCO cancellations were announced on January 23, 1980 (App. 8h). The electric companies' present theory (that *I.D. 138* was a constitutional justification for recovery of the cancellation costs) represents a change in their original position that the Pennsylvania Public Utility Commission actually *lacked jurisdiction* to inquire into their construction program.

electric companies would have had to prove such reasonable reliance to their detriment.

In the competitive marketplace, the economic penalty for excessive or unnecessary construction is levied without appeal. If a competitive firm attempts to include the cost of obsolete, lavish, useless or failed construction in the price of its products, the profits of the firm are directly affected.

The legislature is permitted to conclude that the same economic incentives should be applied to rate regulation of monopoly enterprises. The legislature also is permitted to conclude that it is more efficient, and more effective to prescribe standards for ratemaking which exclude from rate base the cost of plant that is not used and useful in the public service than to depend upon minute, continuous and ubiquitous supervision of utility operations. Both such conclusions are rational and in furtherance of a legitimate state objective. The "used and useful" rule enunciated by the Supreme Court of Pennsylvania is nothing more than a rational application of the police power to a matter wholly within the regulatory powers of the state. As the decision of the Supreme Court of Pennsylvania is adequately grounded in the Constitution of Pennsylvania and in the interpretation of valid Pennsylvania enactments, it should be affirmed. Pennsylvania Constitution, Article 1, Section 10, *National Wood Preservers, Inc. v. Commonwealth of Pennsylvania*, 489 Pa. 221, 414 A.2d 37 (1980), *appeal dismissed*, 449 U.S. 803.

The facial attack upon the Pennsylvania Public Utility Code is invalid and should be dismissed.

II. The Electric Companies' Attack on the Pennsylvania Utility Code as Applied Is Without Merit

A. As applied, Act 335 adequately balances investor and consumer interests.

As interpreted by the Pennsylvania Supreme Court, Act 335 and the Pennsylvania Public Utility Code require that all

cancelled plant costs be excluded from the computation of just and reasonable rates. Neither a return on nor a return of the investment in cancelled plant costs may be charged to consumers (App. 15a). The electric companies allege that, as applied, this precludes the Pennsylvania Public Utility Commission from properly balancing investor and consumer interests and therefore that the statute mandates an unconstitutional taking of its property in violation of the Fifth and Fourteenth Amendments to the United States Constitution.

In narrowly focusing their argument on the denial of cancelled plant costs, the electric companies fail to mention that the Pennsylvania Public Utility Commission rate orders at issue in this appeal granted substantial overall rate increases to each company[22] and that the denial of the investment in cancelled plant costs would reduce the companies' allowed operating revenues by less than one percent. Moreover, in focusing their argument on the treatment of a single and relatively minor element of the many elements that comprise the companies' revenue allowances, the electric companies fail to address properly the standard by which a reviewing court will examine the constitutionality of rate orders.

In determining whether rates are "just and reasonable", as required by the United States Constitution, your Court has held that rates must effectively balance investor and consumer interests with respect to the total impact of the rate order. "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." *Hope Natural Gas*, 320 U.S. at 602. Thus, in order to successfully begin a challenge to the constitutionality of Act 335 as applied, the electric companies must demonstrate, at the very least, that the overall effect, the total effect on its allowed revenues, will have a significant adverse impact on investor interests. The

[22] The Commission granted rate increases amounting to $105.9 for Duquesne (App. 126c) and $15.4 million for Penn Power (App. 110e).

electric companies have failed to make that necessary demonstration.

After nearly fifty years of judicial review regarding details of the ratemaking methods and elements used by regulatory commissions in fixing rates, your Court abandoned that approach in the *Hope Natural Gas* case. *Hope Natural Gas* involved an appeal by an interstate natural gas pipeline company of the rates fixed by the Federal Power Commission (FPC). In reducing the pipeline's rates, the FPC had established an interstate rate base using the book cost less depreciation of the pipelines facilities. On appeal, the pipeline contended that the FPC should have found a higher rate base using the pipeline's proffered estimates of reproduction cost and trended original cost of the facilities. The pipeline also complained of the FPC's exclusion from rate base of certain well drilling expenses and other overhead items that had been previously charged to operating expenses in prior years.[23]

This Court relied upon its earlier opinion in *FPC v. Natural Gas Pipeline Company*, 315 U.S. 575 (1942), to hold that the FPC was "not bound to the use of any single formula or combination of formulae in determining rates[.]" and that under the just and reasonable standard for evaluating the constitutionality

[23] It appears that while the pipeline was still claiming the benefit of a reproduction cost rate base, it invited your court to adopt the kind of "prudent investment" rate base now urged by the Appellants and *amici*. Hope Natural Gas Company argued to your Court that:

> Nothing could be plainer than that in Mr. Justice Brandeis' view, original cost is the amount of money originally paid to establish the utility. He said nothing about the amount of money that was charged to capital accounts on the books of the company and nothing about corrections for accounting errors. He said original cost was a *fact* to be ascertained by an examination of the original work orders, vouchers, books and other records of the company.

Brief on Behalf of Hope Natural Gas Company, at 37, *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

of rate orders, "it is the result reached not the method employed which is controlling." 320 U.S. at 602. Your Court went on to hold that the fixing of just and reasonable rates "involves a balancing of the investor and consumer interests." 320 U.S. at 603. The investor interest was described as follows:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.

320 U.S. at 603. There was no need for your Court to go further in defining the consumer interest side of the balancing standard because in *Hope Natural Gas* the pipeline's investor interests were fully satisfied.

> The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.

320 U.S. at 603.

This Court described in detail the successful financial operations of the pipeline (regular cash dividends, substantial earned surplus, high average earnings, etc.) and concluded that the lower rates established by the FPC were just and reasonable because they nevertheless permitted the pipeline to earn an adequate return after payment of its operating expenses.

> Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they

> might produce only a meager return on the so-called 'fair value' rate base.

320 U.S. at 605.

Consequently, your Court rejected the argument that the FPC erred in failing to consider the pipeline's reproduction cost and trended original cost estimates and the further argument that FPC erred in failing to add certain well-drilling and other costs to the rate base pursuant to a prudent investment theory.

Given this Court's "end result" approach to analyzing the constitutionality of rate orders, the detailed financial examination of rate making methods and elements undertaken since *Smyth v. Ames*, 169 U.S. 466 (1898), came to an end. In its place, *Hope Natural Gas* established new constitutional parameters that emphasize the necessary "balancing of investor and consumer interests" measured with respect to the "total effect of the rate order." Furthermore, *Hope Natural Gas* shifted the constitutional analysis from the valuation of specific assets to the capital invested by stockholders in the enterprise, as suggested by Mr. Justice Brandeis' concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission*, 262 U.S. 276, 289-312 (1923). *Hope Natural Gas* also established a principle of judicial restraint where the legitimate interests of the complaining party are fully satisfied. Because the pipeline company in *Hope Natural Gas* was able to operate successfully and to attract capital even under the reduced rates ordered by the FPC, judicial inquiry as to whether the FPC rate order struck the appropriate balance between investor and consumer interests became irrelevant. 320 U.S. at 605.

Therefore, in order for a utility to initiate a Constitutional inquiry under the Takings Clause as to whether a ratemaking order reflects an appropriate balance of investor and consumer interests, measured with respect to the total effect of the rate order, the utility must demonstrate that its legitimate investor interests have been significantly damaged.

B. The electric companies have failed to allege or prove harm.

In this case, the electric companies have not even attempted to make that demonstration. Unlike *Jersey Central Power and Light Company v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987), where the utility claimed that the denial of certain cancelled plant costs would preclude access to capital markets and damage the firm's financial integrity, 810 F.2d at 1178,[24] the electric

[24] It should be noted that the four judge majority in *Jersey Central* also held that "[t]he Commission is not precluded from employing "used and useful," or any other specific ratesetting formula. Judge Starr, concurring, reviewed the use of the "used and useful" rule by the F.E.R.C. and concluded that if the F.E.R.C. wished to apply the "used and useful" rule to the "enormous" cancellation costs involved in that case, as an administrative agency whose orders must be reviewed by a court, it would have to supply a reasoned explanation. *Jersey Central*, at 1188-1189. Judge Starr agreed with the dissenters that Jersey Central had mounted an "overly broad attack on the 'used and useful principle'[.]" *Jersey Central* at 1188. The four judge minority stated:

> At the heart of Jersey Central's complaint is its dislike of the used and useful principle . . . In its attempt to have the Commission reconsider the doctrine, Jersey Central argues that the precedent does not, or should not, apply to it . . . It is, of course, widely accepted that the Commission may develop principles in one proceeding and then attach precedential or even controlling weight to them in later proceedings.

Jersey Central at 1197.

The minority went on to conclude:

> The majority's sympathy for Jersey Central appears driven by its agreement that the used and useful doctrine is outdated and should be replaced with a pure prudent investment approach. *See* Maj.Op. at 1175, 1180-81 & n.2. By granting a hearing to Jersey Central at this stage of the long and complex ratemaking process, the majority provides the utility a forum in which to argue its causes. But it also interferes with the Commission's discretion in implementing ratemaking policies and procedures. It thereby threatens the well-held maxim that the Commission is 'not bound to use any single formula or combination of formulae in determining rates.' (quoting *Hope Natural Gas* at 602)

Jersey Central at 1215.

It is hardly surprising that the essential gravamen of *Jersey Central* is avoided in the *Brief for Appellants*, at 28, and in the *Brief of the Pennsylvania Electric Association as Amicus Curiae in Support of Appellants*, at 12.

companies are notably silent on the effect that Act 335 would have on their rates. Indeed, the record in this appeal demonstrates that the denial of cancelled plant costs for these utilities will have no significant effect on their financial well-being.

The cancelled plant costs at issue here constitute only a relatively small portion of the total rate base claimed by each utility. For Duquesne, its $34.7 million investment in cancelled plant costs comprises 1.9% of its $1,779.3 million rate base. *See Pennsylvania Public Utility Commission v. Duquesne Light Co.*, 57 Pa.P.U.C. 1, 69-70 (1983). For Penn Power, its $9.6 million investment in cancelled plant costs comprises 2.4% of its $401.8 million rate base. *See Pennsylvania Public Utility Commission v. Pennsylvania Power Co.*, 58 Pa.P.U.C. 305, 365-66 (1984). In terms of allowed operating revenues, the denial of cancelled plant cost amortization has an even lesser significance. For Duquesne, the Pennsylvania Public Utility Commission approved rates that would yield $802.5 million in annual operating revenues; denial of the cancelled plant amortization would reduce that annual allowance by $3.5 million, or by 0.4%. Similarly, for Penn Power, the Pennsylvania Public Utility Commission approved rates designed to yield $184.2 million in annual operating revenues; denial of the cancelled plant amortization, as required by the Pennsylvania Supreme Court interpretation of Act 335, would reduce that annual revenue allowance by $1.0 million, or by 0.5%.

The electric companies have no basis to claim that the rate adjustment required by the Pennsylvania Supreme Court decision, reducing their operating revenues by less than one per-

cent, will have a significant adverse affect on investor interests. Given the relatively insignificant diminution in allowed operating revenues, the electric companies are unable to claim that the reduced rate level would not "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed. . . ." 320 U.S. at 605.

C. Regulation does not insure net revenues, it balances investor and consumer interests.

Even where the record demonstrates a significant adverse effect on investor interests, *Hope Natural Gas* teaches that conditions exist where more or less might be constitutionally permissible since "regulation does not insure that the business shall produce net revenues." 320 U.S. at 603. (quoting *Natural Gas Pipeline Co.*, 315 U.S. at 590). The investor interests described in *Hope Natural Gas* represent only half of the equation since the constitutional standard "involves a balancing of the investor and the consumer interests." 320 U.S. at 603. Thus, modern constitutional principles will permit significant damage to investor interests if justified by substantial and legitimate consumer interests. As explained by the concurring opinion in *Natural Gas Pipeline*, which strongly influenced the majority opinion in *Hope Natural Gas*, "the investor interest is not the sole interest for protection. The investor and consumer interests may so collide as to warrant the rate-making body in concluding that a return on historical cost or prudent investment, though fair to investors, would be grossly unfair to the consumers." 315 U.S. at 607-8.

This principle was applied only one year after *Hope Natural Gas*. In *Market Street Railway Company v. Railway Commission*, 324 U.S. 548 (1945), this Court rejected the argument of an ailing transportation utility that, regardless of the depressed value of its properties due to declining demand and increased competition, it was entitled to a return "sufficient to assure confidence in the financial integrity of the enterprise, so

as to maintain its credit rating and to attract capital." In rejecting the utility argument your Court held that the considerations in *Hope Natural Gas*,

> . . . concerned a company which had the advantage of an economic position which promised to yield what was held to be an excessive return on its investment and on its securities. They obviously are inapplicable to a company whose financial integrity already is hopelessly undermined, which could not attract capital on any possible rate, and where investors recognize as lost a part of what they have put in. . . . Without analyzing rate cases in detail, it may be safely generalized that the due process clause never has been held by this court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce . . . or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities are already impaired. The due process clause has been applied to prevent governmental destruction of existing values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.

324 U.S. at 566-67. (Citations omitted.)

Market Street demonstrates that not all utilities are entitled to the strong financial position described in *Hope Natural Gas* and that the consumers are not required to compensate the utility for competitive losses. In *Market Street* it was "grossly unfair to consumers" to require the payment of higher rates that would only exacerbate the financial problems of a dying utility and accelerate its demise. The precedent of *Market Street* is particularly applicable to this appeal as well. Where changing economic conditions have eliminated the need for cancelled power plants it is up to the states to decide whether investors or consumers or both shall bear the associated risks and losses. In the event that the legislature determines that the risk of

doing business shall be borne by utilities and utilities have been afforded a return upon their investment which includes a return for such risk of business,[25] the United States Constitution is not implicated.

In *Permian Basin*, 390 U.S. 747 (1968), your Court determined that the public interest in efficiently establishing the rates for thousands of natural gas producers by the use of average cost data and area pricing outweigh the investor interests of individual higher cost producers. The practice was not unconstitutional since "[r]egulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interest provide only one of the variables in the constitutional calculus of reasonableness." 390 U.S. at 769 (citing *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 596 (1896)).

Market Street and *Permian Basin* demonstrate that the constitution will permit investor interests to suffer provided that substantial and legitimate public interest concerns can justify that result. Assuming that the denial of cancelled plant costs would damage the electric companies' financial integrity, the consumers' interest in not paying for generating plants that have never provided any electric service to the public easily outweighs the slight harm to investor interests in this case. The record demonstrates that disallowance of the cancelled plant amortization pursuant to Act 335 would reduce each utility's total annual operating revenues by *less than one percent*. The electric companies have not even attempted to argue that this disallowance would not leave those firms with enough revenues to cover their operating expenses and capital costs. Consumers have a compelling interest in not paying for the costs associated with excessive expenditures, mismanagement, inefficient opera-

[25] Duquesne was granted a 16.14% rate of return on equity (App. 93c), while Pennsylvania Power Company was granted a 15.72% rate of return on equity. These returns are substantially higher than the electric companies' cost of debt in order to recognize and compensate equity investors for business risks.

tion, imprudent construction, excess capacity facilities and idle facilities. Stated another way, consumers should bear only the reasonable costs of providing service to the public. In providing that "the cost of construction or expansion of a facility undertaken by a public utility . . . shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the utility is used and useful in service to the public," Act 335 represents a codification of the consumer interest in this regard. The cancelled plants at issue in this appeal never provided service to the public and the consumer interest in not paying for these abandoned projects easily outweighs the slight harm to investor interest in this case.

D. The focus of constitutional analysis is upon the total effect of the rate order as applied, not its effect upon individual assets.

In *Hope Natural Gas*, your Court shifted the focus of the constitutional analysis from individual assets to the total effect of the rate order on investor interest. While the electric companies readily acknowledge this fundamental shift in constitutional analysis, the remainder of their brief focuses entirely on the treatment of specific assets, the four cancelled plants. While the Pennsylvania Public Utility Commission below allowed the recovery of cancelled plant costs from consumers as a matter of state regulatory policy, the denial of all cancelled plant costs in this case does not constitute a taking without just compensation under the constitutional principles outlined by your Court in *Hope Natural Gas* and *Permian Basin*.

There has been no showing by the electric companies that these cancelled plant costs ever became property for the purpose of rate recovery. Under *Board of Regents v. Roth*, 408 U.S. 564 (1972) and *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980) the electric companies must demonstrate that they had something more than a unilateral expectation of recovery of such costs. This they have not

done. Neither the Commission investigation order cited by the electric companies nor the legislative encouragement of the development of nuclear power by "President Eisenhower, each of his successors and the Congress"[26] gave Duquesne Light Company, Pennsylvania Power Company or any other utility *carte blanche* to collect the costs of failed nuclear construction through rates. There was no direction by the Commonwealth of Pennsylvania to the electric companies either to build or to cancel the plants in question. There is no "social contract" or "social compact" which overrides regulation and the public interests protected by the "used and useful" rule. Without such a showing, the electric companies have not made out even a preliminary case for consideration under the Takings Clause. As the Pennsylvania Supreme Court held in a recent case,

> The 'used and useful' concept came into existence long before the *Hope* decision was rendered, and it is not generally regarded as having been overridden by that decision. The concept continues to be of application in this Commonwealth. (citation omitted) Recently, in Barasch v. Public Utility Commission, 507 Pa. 496, 491 A.2d 94, 104 (1985), we noted the legislature's longstanding policy that current ratepayers should shoulder only the costs of providing current utility service, with such costs to be determined by reference to such property as is 'used and useful' in service to the public. . . . The 'used and useful' principle is soundly based, for it serves to protect consumers from exploitation, and it comports with the view that, in fairness, consumers should not be required to buoy up failing utility companies by being required to, in effect, provide public subsidies for utility properties that are not useful in the public service.

Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission, 509 Pa. 324, 333-34, 502 A.2d 130, 135 (1985), *appeal*

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[26] *Brief of the Edison Electric Institute*, at 8.

dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission, 476 U.S. 1137 (1986).

There has also been no showing based on the total effect of the rate order that investor interests have been adversely affected to any significant degree. Moreover, even assuming that the harm to investor interests is significant enough to warrant a *Hope Natural Gas* inquiry into the appropriate balance of investor and consumer interests, the relatively slight harm to investor interests in this case is easily outweighed by the substantial and legitimate consumer interest in not paying for facilities that provide no service to the public.

Under these circumstances, your Court should find that Act 335, as applied, reflects a constitutionally permissible balancing of investor and consumer interests and dismiss the electric companies' facial attack against the Pennsylvania Public Utility Code.

III. The Invitation of the Amici Curiae To Adopt a Risk Free "Prudent Investment" Rule as a Constitutional Standard Should Be Rejected

One may search earnestly for a clear admission by the electric companies and the *amici* supporting the electric companies that *Hope Natural Gas* rejected the "prudent investment" rule as a constitutional test of utility ratemaking.

Yet your Court has so held. In *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 309 (1963), your Court held:

> [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates, [citations omitted] . . . Indeed the prudent investment, original

> cost, rate base method which we are now told is lawful, established, and effective is the very one the Court was asked to declare impermissible in the Hope case, less than 20 years ago.

Wisconsin at 309.

Nevertheless, *amici*, and somewhat obliquely the electric companies, urge that this Court adopt the "prudent investment" model as the benchmark for the constitutionality of utility ratemaking.[27] The Pennsylvania Public Utility Commission urges this Court to reject the invitation.

The "prudent investment" rule, as advanced by Mr. Justice Brandeis in numerous dissents, was an attempt to persuade your Court in the pre-*Hope Natural Gas* era that reliance upon reproduction cost as a constitutional standard was an exercise in delusive exactitude.[28] It is significant that although the major

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[27] The electric companies claim that *Hope Natural Gas* involved a utility challenge to the basing of annual depreciation charges on original cost. From that, the electric companies glean the concept that *Hope Natural Gas* created a constitutional distinction between return *on* an investment and return *of* an investment. Having somewhat mischaracterized that case, the electric companies go on in footnote 25 of *Brief for Appellants*, to bootstrap that mischaracterization into a flat assertion that a denial of rate recovery of prudently invested capital causes investors to "forfeit" the invested funds and creates a *per se* taking. As was discussed in Part I of this Brief, that assertion is untrue. Many items of plant that might be excluded from a utility's rate base for ratemaking purposes still have economic value even if that value must be recovered through a means other than utility rates. It appears that the intent of footnote 25 is to bring utility ratemaking within the scope of this Court's recent decisions on the regulation of real estate, zoning and land use. This attempt is unwarranted, as your Court applies a far higher degree of scrutiny where real estate is involved.

[28] Mr. Justice Brandeis's initial discussion of the "prudent investment" rule occurred in *Galveston Electric Company v. City of Galveston*, 258 U.S. 388 (1922) where he authored the majority opinion. In *Galveston*, the "prudent investment" rate base was defined as "the estimated undepreciated cost of reproduction of railway property of the company on the historical basis, exclusive of franchise value, going concern value, bond discount and brokerage fee," but with land and right of way which cost about $15,000 estimated at their present value of $58,836. *Galveston*, at 258 U.S. 391, n.1.

parties before this Court in the *Hope Natural Gas* argued whether the adoption of the "prudent investment" rule was a preferable standard to that of *Smyth v. Ames*, your Court de-

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By the time he dissented in *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 289-312 (1923) "prudent investment" had changed to become the original cost of the property not excluding "investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures." *Southwestern Bell Telephone*, at 289 n.1. The last major dissent on the basis of "prudent investment" was in *United Railways and Electric Co. of Baltimore v. West*, 280 U.S. 234 (1930), in which Mr. Justice Brandeis declared that "if, instead of applying the rule of Smyth v. Ames, the rate base of a utility were fixed at the amount prudently invested, the inevitable errors incident to estimating service life and net expense in plant consumption could never result in injustice either to the utility or to the community." *United Railways*, at 280 U.S. 279. It is significant that Mr. Justice Brandeis joined in the majority opinion in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*, 289 U.S. 287 (1933), in which Mr. Justice Hughes, supporting a $3 million deduction from a fair value rate base to eliminate an obsolete plant, wrote:

> "The actual cost of the property—the investment the owners have made—is a relevant fact. (citing *Smyth v. Ames*). But, while cost must be considered, the Court has held that it is not an exclusive or final test . . . Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public."

Los Angeles Gas, at 289 U.S. 306.

Mr. Justice Brandeis retired from the Court in February 1938, and his "prudent investment" rule was never adopted as a Constitutional standard.

clined to adopt a new rule of substantive due process where the old one had failed.

Amicus curiae PEA dangles the enticing prospect that adoption of the "prudent investment" rule will reduce litigation.[29] This cannot be so, for experience teaches that adoption of such standards results in an explosion of litigation.[30] Instead of courts focusing upon what the end result of a specific rate order is upon a specific utility company's financial condition, courts would become bogged down in defining in thousands of regulatory cases of what constitutes "prudence", and what level of prudence is required under the U.S. Constitution; federal courts would return to the unhappy days of reviewing state regulatory decisions on the basis of rules rather than reality. Further, it would involve the federal courts in reweighing the legislation of the states for encroachment on the new penumbra of the "prudent investment" standard.

Fundamentally, it would also require your Court to overrule *Hope Natural Gas* and *Permian Basin* and the constitutional recognition given to consumer interests. Under the risk-free "prudent investment" theory advocated by *amici* the utility investor would be guaranteed a profit on each investment regardless of changed market conditions, feckless utility management

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[29] "[A]micus submits that the appropriate approach," both to secure constitutional values and to protect this Court's docket from the burden of reviewing a plethora of rate decisions, is to adopt the prudent investment test of Justice Brandeis as the constitutional benchmark" *Brief of Pennsylvania Electric Association*, at 23.

[30] For a review of the cases engendered by the *Lochner* era and the adoption of the *Smyth v. Ames* standard of valuation, *see generally*, Siegel, *Understanding the Lochner Era*, 70 Va. L. Rev. 187 (1984). Mr. Justice Brandeis dolefully observed in *Southwestern Bell Telephone* at 262 U.S. 311 (1922) that: "The rule by which the utilities are seeking to measure the return is, in essence, reproduction cost of the utility or prudent investment, whichever is the higher." It is ironic that the electric companies and their Pennsylvania and national associations are here contending for a standard that was anathema to the utilities during the *Smyth v. Ames* era.

or even complete destruction of the plant. In short, investors would be insulated from business risks. *Hope Natural Gas* and *Permian Basin* recognized that the utility business is not risk free and that consumers have legitimate interests which must be fulfilled through the exercise of state police power. Where appropriate, those interests must be fulfilled even at the expense of investor interests.

It would be ill-advised to overturn well established precedent upon the facts of this case. Neither the appellants, nor the *amici curiae* present even a colorable picture of national need for such a break in constitutional doctrine, and precedent of such longstanding should not be abandoned for light and transient causes.

CONCLUSION

This Court should affirm the judgment below, or in the alternative, dismiss this appeal for want of a substantial federal question.

Respectfully submitted,

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